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Executive Summary

Towards a Single European Market in Asset Management

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Executive summary

Part A The vision

Ten years after the “completion” of the single market, national borders continue to define and restrict economic activity, even within the Eurozone. This is particularly true of the market for asset management, where a significant gap persists between the vision of a single market and the present reality.

This report envisages that a single market for asset management would exhibit the following features:

- A consistent and flexible legal and regulatory framework which avoids excessive or repetitive regulation;
- Absence of fiscal discrimination against foreign asset management products;
- Sufficient consumer education and comparable information on financial products to minimise consumer discrimination against foreign asset management products;
- No competitive discrimination against third-party asset management products (whether foreign or domestic) by distributors;
- Sufficient information and institutions to reassure consumers of the reliability of cross-border contracts;
- Continuous improvement of the pan-European infrastructure which facilitates transactions between asset managers and consumers; and
- Openness of non-European markets to European asset management products, and vice versa.

A single market that fulfilled this vision would provide significant economic benefits to both consumers (e.g. cost savings) and society (e.g. higher economic growth due to faster and more efficient capital accumulation).

It is hard to make any general statement about the asset management market, since in reality it comprises a large number of sub-markets and products (from highly standardised fund products for retail clients to highly individualised segregated services for institutional clients). This report has a certain – though not exclusive – focus on retail investment fund products, for which more data is available and, more importantly, the distance between vision and the reality is greater than in the wholesale market.

Part B Integration shortcomings

The study assesses the status of the single market by analysing extensive aggregate data and one-to-one interviews with leading investment management companies with significant cross-border business.

Aggregate data paints an ambivalent picture of the current degree of integration:

- While there is some growth in the volume of cross-border investment fund sales, national markets are still predominantly dominated by domestic suppliers. In most European countries the market share of foreign investment funds (by asset value) rarely exceeds 20%.
- There is strong evidence that third party distribution is driving cross-border business in European investment funds.
- European UCITS have enjoyed some export success outside of Europe, for example in Asia and Latin America. However, the world's largest market, the US, is practically inaccessible to European UCITS due to regulatory constraints.
- In most European countries, banks still dominate the distribution of investment funds. Furthermore, banks still largely prefer to sell in-house products: more than 80% of all investment fund assets are attributed to in-house funds. However, this picture is beginning to change. Survey respondents indicated, on the one hand, that the dominant position of banks is beginning to be challenged, and, on the other hand, that the banks' movement towards 'open architecture' will increase the distribution of third-party cross-border products .

Part C The issues in detail

There is no simple answer as to why the European market for asset management is still segmented by national borders. However, interviews with asset management firms engaged in cross-border business indicated that certain 'man-made' barriers are a greater obstacle to the single market than 'natural' barriers like language, including (and in order of importance): taxation; distribution; fund mergers; infrastructure; and registration. Other (largely consumer related) barriers such as consumer culture or lack of consumer confidence were generally considered less significant obstacles to a single market.

- **Taxation:** Tax discrimination against foreign investment funds was deemed the most significant barrier to cross-border business. Interviewees attributed the highest weighting to taxation independently of their particular business model. This assessment is consistent with empirical research: countries with fiscal regimes which radically discriminate against foreign UCITS are practically closed to cross-border business.

- **Merger of funds:** Existing research leaves no doubt that the fragmentation of European markets along national borders results in sub-optimum average fund sizes. Consumers pay the bill for small funds in the form of high cost ratios. Tax and regulatory barriers restrict the ability of asset managers to increase average fund sizes by merging, eliminating or re-structuring existing fund ranges. For example, some regulatory regimes place prohibitive conditions on mergers which would move assets to other domiciles, whereas some fiscal regimes treat cross-border mergers as a taxable event.
- **Distribution:** Asset managers typically rely on third-party distributors of investment funds (including banks and others) to enter new markets. Interviewees identified insufficient willingness and competence on the part of the sales staff of third party distributors as significant obstacles to the single market. Those supply side barriers are reinforced by insufficient financial literacy on the part of retail investors to demand appropriate advice from distributors and products from cross-border asset managers. Although the market downturn since the year 2000 may temporarily set back the trend towards open architecture, ultimately it is expected to resume and may even be reinforced by the recent experience of consumers.
- **Infrastructure:** There is a relatively large gap between the current state of the infrastructure that processes transaction between asset managers and their clients (which is characterised by inconsistent and repetitive protocols and standards), and an economically ideal infrastructure (which would be characterised by 'straight through processing' (STP)). Movement toward an economically ideal infrastructure would remove a costly barrier to cross-border sales of investment funds. There are reasons to believe that "the market" will move toward an optimal solution of its own accord, without any intervention from legislators other than to remove legal and regulatory barriers that restrict the market from finding this solution.
- **Registration:** Fund registration (i.e. the requirement to register a UCITS fund in every host state in which it is actively marketed, irrespective of having already been registered in its home state) is regarded as giving rise to unnecessary additional expenses which put cross-border investment funds at a cost disadvantage to domestic investment funds. While the direct registration fees paid to domestic regulators are relatively low, indirect fees paid to local lawyers and accountants can be significant.
- **Consumer culture:** Whilst cultural differences impact the means of distribution, they only represent a moderate barrier to the development of a single market. National prefer-

ences for certain asset class, time horizons, and cost arrangements can all be accommodated by asset managers.

- **Consumer protection:** Consumer protection standards (for example, regulating the marketing and advertising of investment funds, and supplementary advice and information publication) vary significantly between EU member states. Cross-border investment fund business is only moderately inhibited by the variety of regulation. Consumer confidence in cross-border business can be strengthened through institutions such as cross-border complaint networks, compensation schemes, codes of conducts or well defined standards on advice. While asset managers do not agree on the importance of unified standards in *all* of these areas, they *do* agree that any standards should be defined by the industry itself rather than the legislators (since the industry has the best information about adequate rules).
- **Information issues:** The asset management industry (and, indeed, the broader financial services industry) is characterised by information asymmetry between the investor and the provider. National regulations and market practices manage that asymmetry by establishing investor information standards (for example, relating to fund costs and performance). The variety of national information standards makes it difficult to compare investment funds on a cross-border basis, and therefore inhibits the single market. The simplified prospectus (constituting a single, fully harmonised pan-European document – possibly along the line of the FEFSI proposal - that can be used for the cross-border marketing of UCITS in all countries) would be a useful step in reducing the variety of information standards.
- **Transparency:** Fees and charges are often not transparent to consumers and hence not comparable between different investment funds, particularly on a cross-border basis. Similarly the reported performance of investment funds is rarely comparable on a cross-border basis. Almost all interviewees argued that the asset management industry should standardise such information to improve transparency and comparability (incidentally arguing that regulators and legislators were less well equipped and resourced for this task).
- **Legislative and regulatory issues:** Even though the revised UCITS Directive is expected to promote the single market for investment funds, significant shortcomings remain. For example: potentially diverse implementation between member states; tax discrimination; and regulatory discrimination. Similarly, the draft directive on occupational retirement pensions leaves a lot to be desired since it provides member states with a lot of discretion, for example, to impose qualitative restrictions on the asset allocation of pension funds or to fiscally discriminate against cross-border contributions.

Part D What needs to be done

There is a broad consensus amongst asset managers, regulators and legislators on the benefits of a single market. However, there is less consensus on how to achieve those benefits. Legislators are naturally optimistic that legislation and directives will be sufficient to promote future integration. In contrast, the asset management industry places more emphasis on better coordination, stricter enforcement and standardised implementation of existing legislation in the post-FSAP era. This report finds that such issues cannot be generalised: different problems require different solutions, sometimes legislative, sometimes interpretative, and sometimes judicial. Therefore, our case-by-case recommendations are:

- **Taxation:** Tackling tax discrimination against foreign investment funds must be prioritised if one takes a single market seriously. To date, the asset management industry and Commission have been reluctant to tackle discrimination for different reasons (the former because it is concerned about alienating member States, and the latter because of conflicting priorities). However, ultimately it is the Commission's responsibility (as guardian of the Treaties) to address this issue and adopt a more aggressive judicial approach.
- **Fund mergers**: Two distinct problems need to be addressed: first, the treatment of fund mergers as taxable events and second, protectionist regulatory conditions on outward-bound cross-border mergers. Responsibility for correcting the former lies with member states, and for correcting the latter with the Commission (for example, by proposing a future UCITS amendment to simplify and harmonise the rules for relocating investment funds within the single market).
- **Distribution**: Competition will naturally force suppliers to open up their distribution network to third party products. Improving consumer literacy is likely to mildly accelerate this process. Improving national regulation of advice in order to promote unbiased and objective distribution is likely to be a more significant driver. Progress towards more open distribution is closely linked to progress towards a more efficient European infrastructure.
- **Infrastructure**: Today, fragmentation of infrastructure places a costly burden on cross-border sales of investment funds. An efficient, pan-European infrastructure would require a significant initial investment, during the course of which investors would face uncertainty as to which standards would finally prevail. Although the market may take a long time to resolve these issues, it is better placed than other parties to arrive at an effective solution. Therefore this report recommends that improvements in infrastructure be primarily left to market forces and competition between leading infrastructure service providers, with a secondary role for the European Commission to speed up the process by removing any legal and regulatory barriers.

- **Registration**: Current UCITS registration practices inhibit the single market. A straightforward solution would be to take the European passport literally: a fund accepted as a UCITS in its home state would be immediately marketable elsewhere in the EU without further registration requirements. This would be a significant breakthrough and should be considered seriously in future debates about the UCITS Directive.
- **Transparency/information requirements**: The simplified prospectus as introduced by UCITS III is a helpful step in the right direction. However, it does not solve the problem of heterogeneous national requirements on full prospectuses. Future reforms should establish a harmonised full European prospectus that would be sufficient in each member state (and which would complement the preceding recommendation to abolish registration of UCITS in every host state). The asset management industry can speed up this process through self-regulated harmonisation of cost and performance reporting. In addition, it is important to improve the education of consumers.
- **Evaluation of legislation:** What is definitely needed prior to any further legislation is a more critical evaluation of past legislative measures. This is particularly important with respect to FSAP initiatives, the effects of which should be properly monitored and measured before moving on to further legislative programmes.